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SUBJECT: EU Financial Supervisory Framework: Standing on the Edge of the Future

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¶1. (SBU) Summary: The EU-wide financial supervisory framework created and made operational in less than three years is about to come into its own. The three new supervisory committees, the Committee of European Securities Regulators (CESR), the Committee of European Banking Supervisors (CEBS) and the Committee of European Insurance and Occupational Insurance Supervisors (CEIOPS) will play a central role in implementing recent legislation that has basically retooled the EU financial services framework. CESR, the oldest of the three, is leading the way. In one paper CESR laid out its implementation activities and, in a separate provocative think piece, asks the question, "What if intensifying coordination among national supervisors is not effective?" One possible answer: give "the Network" of national supervisors legal and supervisory powers to deal with trans-EU issues. This is like standing on the edge of the future.

¶2. (SBU) The European financial industry has cut through practical, legal and political niceties by calling for the creation of a lead regulator. While this has attracted push back from CEBS and the European Central Bank (ECB), the recently approved Capital Adequacy Directive (CAD III) incorporates the concept of "coordinating supervisor," a possible step along the way to a lead supervisor. Ensuring political accountability will be essential before the EU progresses to a unified supervisor. The idea, however, is irresistible to some. Deutsche Bank, for example, welcomes the current trend and is dusting off its old piece: A European Financial Supervisory Authority - A Matter of When, Not If." End Summary

Committee Creation: Back Waters No Longer

¶3. (SBU) In a short three and a half years CESR, CEBS, and CEIOPS, each composed of all relevant member state supervisors, have been created and become operational. CESR was the first. Created in June 2001, CESR was conceived upon a recommendation by a group of wise men led by Alexander Lamfalussy (the Lamfalussy Group). Lamfalussy, who headed up the precursor to the ECB, reasoned that knitting European financial markets closer together would require a flexible regulatory process to respond to dynamic markets and close cooperation among national supervisors to ensure uniform implementation on a pan-EU scale. Finance Ministers replicated this basic approach in agreeing at the end of 2002 to create CEBS and CEIOPS. Like CESR, CEBS and CEIOPS were matched by regulatory committees composed of Finance Ministry representatives. The Financial Services Committee, which reports to ECOFIN, takes an overview and sets strategic directions. Details of CEBS and CEIOPS took a while to resolve. Both opened their doors for business in the fall of 2004.

¶4. (SBU) Granted, each of these committees had precursors. What is different is that they all have a formal role in providing advice to the Commission on Financial Legislation and Regulation, and in ensuring consistent implementation of EU legislation in member states. The European Council's Stockholm Resolution that gave birth to CESR states that "national regulators and CESR should also play an important role in the transposition process by securing more effective cooperation between supervisory authorities carrying out peer reviews and promoting best practices, so as to ensure more consistent and timely implementation of community legislation in member states." Precursor supervisory committees were largely voluntary, with no space or only a small space in the formal EU regulatory framework. All this is about to change.

Long "To Do List:" Implementation Begins

¶5. (SBU) Implementation of legislation now has become the

focal point for EU financial services activities. The Financial Services Action Plan has retooled basic elements of EU securities legislation and now will have to be implemented. CESR is helping with the implementation of the Market Abuse and Prospectus Directives, the Regulation on International Accounting Standards, and amendments to the Directive on Undertakings in Collective Investments in Transferable Securities (UCITS). In the wings is implementation for the more recently adopted Directives on Markets in Financial Instruments (MiFID) and on Transparency.

¶6. (SBU) Even though their legislative list is not as long as CESR's, the other two committees will have responsibility for implementing major new directives. CEBS is beginning its implementation work for the Capital Adequacy Directive (CAD III) that will fundamentally change risk capital assessments for financial institutions. CAD III is being finalized by the Council and is pending in the European Parliament. CEBS is designing a common reporting framework for capital requirements and the solvency ratio, has published draft guidelines on the supervisory review process, and introduced "prudential filters" aimed at neutralizing the effects of new accounting standards on regulatory capital. CEIOPS is gearing up to provide advice for the Commission's major rewrite of capital adequacy rules for insurance firms (Solvency II). The Commission is likely to make a proposal in 2006 or early 2007.

Implementation: Where the Rubber Hits the Road
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¶7. (SBU) The logic of an integrated financial market is that all players to follow the same rules. This can help ensure healthy competition and a relatively efficient allocation of capital. In highly competitive and regulated financial markets, this also implies that the rules be enforced in the same way. Lax enforcement might be considered to gain a competitive advantage, like an "off-shore" financial center. Such an approach would put a quick end to "mutual recognition" of one member state's supervisory surveillance by another, the cornerstone of the internal market.

¶8. (SBU) CESR has done the most public thinking on this topic. In a paper released at the end of October, CESR used three groups to categorize its implementation functions (so-called "Level 3" functions, Level 1 being the directives, Level 2 being the implementing measures regulations or follow up directives, and Level 3 being the nitty gritty of issuing rule books and supervisory guidance explaining how firms are expected to comply with the directives and regulations). These are: (1) coordinated implementation of EU law; (2) regulatory convergence; and (3) supervisory convergence.

¶9. (SBU) Coordinated implementation involves the legal transposition of directives into national laws and their day-to-day application. CESR has established a Review Panel to carry out peer reviews using correspondence tables detailing how directives are being implemented in each member state. CESR members are to provide a self-assessment on their implementation. The Review Panel will offer an opinion and suggestions for common approaches to implementation. The correspondence tables, assessments and opinions would be made public. To ensure consistent enforcement in all member states CESR has recommended that CESR members be granted equivalent rulemaking and enforcement powers by their respective national authorities.

¶10. (SBU) Regulatory convergence is defined by CESR as creating common approaches. Each supervisor takes decisions that create a body of jurisprudence in its jurisdiction. Acting together, CESR notes that its members can decide on common approaches that could be memorialized in meeting minutes, indicative guidance, or regulatory recommendations. These would not have the status of EU law, but be implemented on a "voluntary basis" by all supervisors. Areas that are subject to such regulatory convergence need not be covered by EU law, in CESR's opinion. CESR's recent standards on clearing and settlement developed together with the ECB are an example. CESR also has worked on guidelines on implementation of the Market Abuse and Prospectuses Directive and has begun work on guidance for certain mutual fund issues.

¶11. (SBU) Supervisory convergence relates to how supervisors approach the practical operation of rules and legislation. This means strengthened cooperation in practical ways. One is to pull together provisions in directives that mandate mutual recognition and cooperation into one consolidated text. CESR thinks this would serve as the basis to handle all situations requiring cooperation among supervisors. In another practical implementation measure, CESR plans to set up a "mediation mechanism by its peers" to provide an acceptable solution where "home" and "host" supervisors disagree. Joint supervisory visits and investigations by

CESR members and compiling "EU jurisprudence" in a database of national decisions are other CESR initiatives to strengthen cooperation and, thereby, supervisory convergence.

¶12. (SBU) CESR develops these ideas further in another, provocative thought piece entitled "Preliminary Progress Report: Which Supervisory Tools for the EU Securities Markets?" This paper, referred to as the "Himalayas Report," given its lofty perspectives, elaborates the three categories of implementation functions cited above. CESR sets the tone by proclaiming its "serious objective" is to "enhance its role as the `supervisor of national supervisors.'" In this regard CESR suggests that its network of supervisors might consider more systematic peer reviews on member state implementation with "mission teams" making assessments and CESR publishing results where implementation is inadequate.

¶13. (SBU) A more robust mediation mechanism could require mediation where there are disagreements or lack of cooperation among supervisors.

¶14. (SBU) In the Himalaya paper CESR ventures onto the area of supervision of trans-European activities, such as investment firms, raising questions as to whether cooperation can be efficiently executed by many separate authorities, particularly in a financial crisis situation. Other areas demanding a possible pan-EU approach include public offerings, standard mutual funds, the application of accounting standards for listed companies, the regulation of credit rating agencies, and trans-European market infrastructures (exchanges and clearing and settlement systems). CESR muses whether its network should take single EU decisions on such matters. Backing up a bit from the edge, CESR reflects that a "trans-national" option is risky and should not be attempted unless the present system cannot provide proper solutions to supervisory convergence. Different local laws, regulatory powers and jurisdictions, and political accountability at the EU level present real obstacles to a pan-EU solution.

Industry: Leading the Way to the Lead Supervisor?

¶15. (SBU) The European Financial Services Roundtable (EFSR) cuts through the worrisome details and recommends that the trans-national option be exercised now, calling for a "lead supervisor for prudential supervision of cross-border financial institutions." The EFSR proposes that the lead supervisor would be the single point of contact for the financial institution within the prudential supervisory framework, receiving all reports, validating and authorizing internal models, approving capital and liquidity allocation, and approving cross-border set up of specific functions. Local supervisors would be involved in supervision based on delegated authority from the lead supervisor. The lead and local supervisors would set up "colleges" to advise the lead supervisor, and the relevant supervisory committees, such as CEBS, could mediate any disagreements. In the Roundtable's opinion, the lead supervisory regime will not only improve the quality of supervision at an acceptable cost, but also be an important catalyst for convergence of supervision towards best practices.

Dutch Nudge: Just Thinking Out Loud

¶16. (SBU) The Dutch Presidency gave the notion of lead supervision a bit of a nudge. In a November seminar on "Enhancing Supervisory Convergence," Dutch Finance Minister Zalm raised questions as to whether present coordinating mechanisms were effective, delivering as promised, and efficient. He opined that different supervisory practices in different member states can "cause market distortions." Good supervisory arrangements, in his judgment, should stimulate rather than hamper the integration of European financial markets. Noting that national supervisors can only operate under national mandates, he mused whether there should be "thinking about more European solutions for supervision of truly European financial groups. Although we should not try to cause a revolution here, we are likely to see an evolution towards more European supervisory structures."

CAD III Coordinating Supervisor: Planting the Seed

¶17. (SBU) The proposed CAD III contains a potential seed for a lead supervisor. According to the Commission's proposal draft, the coordinating supervisor is the member state authority that has responsibility for supervision of a financial institution on a consolidated basis. This supervisor needs to work with other relevant authorities of jurisdictions in which the institution is present to validate technical aspects of CAD III. Such aspects include

the risk-weighted exposure amounts using the Internal Ratings Based Approach, the estimates of loss given defaults, and the use of Advanced Measurement Approaches based on internal risk measurement systems. However, if no agreement is reached within six months among the coordinating and other competent supervisors, the coordinating supervisor can make its own determination. That determination will apply to the entire institution throughout the EU.

¶18. (SBU) This approach encountered opposition. A member of the Bundesbank board, for example, was adamantly opposed, citing national responsibility for subsidiaries of parent institutions located in other member states. The ECB, however, did not resist. It observed that there is a large gap between what the lead supervisor championed by industry and the coordinating supervisor envisioned in CAD III. Nonetheless, the challenge is apparent.

¶19. (SBU) The Chairman of CEBS, Jose Maria Roldan, has taken up that challenge. He does not share EFSR's view, explaining that rather than having a "one-stop-shop," a "more pragmatic approach is needed" within the present institutional framework. Indeed, CEBS staff believe that their main objective is to show that more intensive cooperation is the solution. German Finance Ministry officials, however, believe the coordinating supervisor concept in CAD III as a step toward a single EU supervisor. A Dutch supervisor put it another way: if a coordinating supervisor approach cannot be made to be effective, then the option of going straight to an EU supervisory authority will gain currency.

Got the Move, But Not the Political Touch

¶20. (SBU) In the end, politics hold the key to any trans-EU solutions. The Chairman of the European Parliament's Economic and Monetary Affairs Committee livened up CESR's December gala by lamented the "democratic deficit" of some of CESR's ideas. Who is in charge of CESR? CESR is sensitive to this issue. In its Himalaya paper CESR noted that it is "firmly determined to develop its political and democratic accountability links vis--vis the Finance Services Committee, the European Commission and the European Parliament."

¶21. (SBU) The Inter-Institutional Monitoring Group (IIMG) also is cautious about the politics and the EU "institutional balance," meaning power sharing between the Commission, Parliament and Member States in the Council. The IIMG, composed of representatives from all three EU institutions, has endorsed coordinated implementation, supervisory convergence and CESR's proposed mediation mechanism. On regulatory convergence, however, it was "more reserved." The IIMG worried that the "multiplication of non-binding rules at Level 3 should not lead to a gray area where legal certainty is absent and political accountability is unclear."

¶22. (SBU) The draft Constitutional Treaty addressed some of the political questions. Article 35 would give the European Parliament the right to block the entry into force of regulations delegated to the Commission in directives, power that the Parliament now has only by the grace of a political understanding with the Council. The Constitution also states "where uniform conditions for implementing binding Union acts are needed, those acts may confer implementing powers on the Commission." There is no mention of Parliament's role or of the accountability of supervisory authorities, so some questions still appear to be open.

Comment:

¶23. (SBU) If process defines outcomes, the implementation phase of EU-wide financial service legislation will be an interesting process. Getting the politics right is essential. The power of the idea of regulatory convergence would seem irresistible for those that wish the EU to be truly an integrated financial market. The questions raised by CESR and Dutch Finance Minister Zalm on the limits of national supervisors coordinating to oversee pan-EU activities are unavoidable. Officials at Deutsche Bank welcome the trend of the current thinking. They are dusting off their old think piece: "European Financial Service Authority - A Matter of When, Not If."

¶24. (U) This report coordinated with Embassies Berlin and The Hague and USEU Brussels.

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